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In the Supreme Court of the United States

OCTOBER TERM, 1979

E. I. DUPONT DE NEMOURS & COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Petitioner seeks review of the decision of the Court of Claims upholding the Commissioner's determination of a deficiency under Section 482 of the Internal Revenue Code of 1954 (26 U.S.C.). That provision grants the Commissioner of Internal Revenue authority to reallocate income among commonly controlled trades or businesses "in order to prevent evasion of taxes or clearly to reflect" their income. The Commissioner may invoke the statute in any instance in which, either by plan or by result, the taxable income of such companies is other than it would have been had the parties dealt with one another at arm's length. Treasury Regulations on Income Tax, Section 1.482-1(c) (26 C.F.R.); B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 15.06 (4th ed. 1979).

The pertinent facts may be summarized as follows: On audit, the Commissioner determined that petitioner's sales of its products to its wholly-owned international Swiss sales subsidiary, DuPont International, S.A. (DISA), were made at unrealistically low prices, and that consequently a substantial amount of petitioner's income (which would have been subject to United States tax) had been diverted to the Swiss subsidiary. Accordingly, the Commissioner allocated part of DISA's income back to petitioner and imposed United States tax on the reallocated income.

In this refund suit brought by petitioner in the Court of Claims, the court found, after a lengthy trial and analysis of a comprehensive record, that petitioner had intentionally sold goods to its Swiss subsidiary at prices far below their fair market value, so that its subsidiary could resell them at much higher prices and thereby generate large profits which would be subject only to low Swiss tax (Pet. App. A-3 to A-5). The court held that there was no proof to support petitioner's claim that the intercompany prices were equal to those that would have been charged at arm's length; instead, it concluded that the evidence convincingly demonstrated that the prices as reconstructed by the Commissioner—and the resulting reallocation of income—were reasonable (Pet. App. A-22 to A-23).[1]

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[1]Petitioner's statement of the salient facts refers (Pet. 2) to a "dramatic increase in sales of petitioner's products for which DISA was responsible." However, the court's Finding of Fact No. 100 states that "During the period in suit DISA's presence and participation in the marketing of [petitioner's] products increased neither the volume of [petitioner's] sales in the area serviced by DISA nor the unit prices obtained for the products involved in those sales."

Similarly, petitioner ignores all of the evidence which, as summarized in the court's opinion, shows that DISA was "a subsidiary intended and operated to accumulate profits without much

1. Petitioner first contends (Pet. 6-11) that the Court of Claims misapplied a provision of the governing Treasury Regulations promulgated under Section 482. Specifically, it charges (Pet. 11) that the court "read the resale price method out of the regulation" when it found that (Pet. App. A-18) "the record before us does not support use of that formula for this case."[2]

The resale price method requires comparisons between the gross profit margins allowed the "controlled" reseller (*viz.*, DISA) to those markups actually earned by "uncontrolled" (*i.e.*, independent) resellers whose operations and circumstances are substantially similar to

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regard to the functions it performed or their real worth" (Pet. App. A-7); that "the pricing system was based solely on [petitioner's] Treasury and Legal Department estimates of the greatest amount of profits that could be shifted to DISA without evoking IRS intervention" (Pet. App. A-6); that, with respect to a substantial portion of the products channelled through petitioner's Swiss affiliate, "the sole reason to sell them through DISA seems to have been to increase the volume of profits for that special subsidiary" (Pet. App. A-20); and that the prices to DISA were so artificially low that DISA was able to realize profits which, as measured by recognized economic indices, "vastly exceeded the uppermost limits" of the most successful businesses in the economy (Pet. App. A-22). The underlying facts and data supporting the above conclusions are detailed in the Findings of Fact (see Nos. 36-79, 88, 90-92, 122, 125-139) which are reported at 78-1 U.S.T.C. para. 9374, at 83,911-83,972 (Ct. Cl. 1978).

[2]The Regulation in question (Section 1.482-2(e)) describes, in order of preference, three specific methods for ascertaining an arm's-length price for sales of tangible property between related parties (the comparable uncontrolled price method, the resale price method, and the cost plus method). It further states (Section 1.482-2(e)(1)(iii)) that "[w]here none of the three methods of pricing * * * can reasonably be applied under the facts and circumstances as they exist in a particular case, some appropriate method of pricing other than those described * * * can be used" (Pet. App. C-3).

the controlled entity.[3] By its terms, the application of the resale price method involves a two-step process: First, those "uncontrolled" transactions that bear a close resemblance to the "controlled" situation must be found, giving particular attention to similarities as to the type of property and geographic markets involved and the functions performed by the resellers. Second, "appropriate adjustments" must be made to the arm's-length markup percentages which are used for comparison purposes to reflect, and to compensate for, each and every difference between the "functions or circumstances" of the "controlled" reseller and those of the "uncontrolled" resellers. Treasury Regulations, Section 1.482-2(e)(3)(vi) and (ix). As the Court of Claims explained, the "uncontrolled" resellers that petitioner sought to equate to DISA were so fundamentally and completely different in all material respects as to render comparison of their respective gross margins meaningless[4] (Pet. App. A-12 to

[3]A reseller's gross margin or markup is the price discount or concession which it can command from its source of supply. The amount of such a discount is dependent upon market conditions, the nature and extent of the reseller's services, and the obligations and risks which it assumes. As the proof in this case graphically demonstrated, there is no such thing as a typical, normal, or prevailing gross markup percentage for resellers generally. Indeed, examples ranged from near zero to 50 % (Findings of Fact 81, 110).

[4]As the Court of Claims correctly observed, the only similarity between DISA and petitioner's alleged "comparables" was that each resold manufactured goods (Pet. App. A-12). Furthermore, in addition to the basic differences as to products, markets, and functions, the court also noted that DISA's circumstances were especially unique insofar as petitioner and its subsidiaries performed much of DISA's technical work for it and without charge, provided DISA with many of its trained employees, afforded it favorable credit terms, insured DISA against any risk of loss upon resale, and, in certain instances, granted DISA large discounts on products even though its participation in the transactions was not really needed (Pet. App. A-6 to A-7, A-20).

A-15, A-17). Moreover, as the court observed, petitioner never proposed any means by which to adjust for any of the myriad of differences as to "functions or circumstances" (Pet. App. A-15 to A-16).

Contrary to petitioner's assertion (Pet. 2, 8), the Court of Claims did not state that "essentially identical," "or near-identical," arm's-length transactions were a prerequisite to application of the resale price method. Quite to the contrary, the court explicitly said that comparisons to "substantially comparable" uncontrolled resellers would suffice (Pet. App. A-10). By the same token, the Court of Claims did not rule, as petitioner contends (Pet. App. A-2, A-6, A-11), that its interpretation of the Regulation would make it "very difficult" or even "impossible" for any taxpayer to successfully apply the resale price method. Instead, the court simply noted that where, as here, a taxpayer formulates an arrangement to channel its own income to what petitioner itself called its "profit sanctuary trading company" (Pet. App. A-4 n.4) by means of bargain sales of its products, it is most unlikely that such taxpayer would be able to find equivalent transactions occurring at arm's length (Pet. App. A-8, A-18).

2. Petitioner further argues (Pet. 6) that the Court of Claims' "decision conflicts with pertinent legislative history." In this respect, petitioner contends that Congress mandated the promulgation of the Section 482 pricing Regulations and that the Regulations require the Commissioner to use one of the three specified pricing methods. In petitioner's view, it therefore follows that no allocation of income is permissible unless the government

affirmatively proves that the Commissioner's determination is in conformity with one of the pricing methods described in the Regulations (Pet. App. A-11 to A-12).

To begin with, petitioner's argument disregards the well-settled proposition that in a suit challenging the Commissioner's determination under Section 482, it is the taxpayer, not the government, that bears the burden of proof. Accordingly, no recovery is allowable in a Section 482 case unless the taxpayer establishes the correct amount of its true taxable income. *Eli Lilly and Co.* v. *United States*, 372 F. 2d 990, 997 (Ct. Cl. 1967); *Lufkin Foundry and Machine Co.* v. *Commissioner*, 468 F. 2d 805 (5th Cir. 1972); *Wisconsin Big Boy Corp.* v. *Commissioner*, 452 F. 2d 137 (7th Cir. 1971).

At all events, in the presentation of its case, the government attempted to apply, *inter alia*, the resale price method in the light of the available evidence (Pet. App. A-18 n.24). Recognizing the probable inapplicability of that method (as well as of the uncontrolled price and cost plus methods), the government then proceeded in the manner directed by the Regulations (Section 1.482-2(e)(1)(iii)), *viz.*, to devise some other "appropriate method of pricing." The Court of Claims concluded that, in view of the inapplicability of the first three specified pricing methods, recourse to the government's other approaches was both proper under the Regulations and highly probative (Pet. App. A-21 to A-23). Thus, the government established to the Court of Claims' satisfaction "that DISA made extraordinarily high profits which the Commissioner reallocated to an economically reasonable level" (Pet. App. A-22), and it made this showing in full compliance with the Regulations.

3. Finally, petitioner contends (Pet. 6, 12-14) that the Court of Claims' ruling is "at odds" with various Section 482 decisions of the Tax Court and the Fifth and Seventh Circuits. But a Section 482 pricing inquiry is essentially a factual determination, turning upon the particular evidence presented in each case. Significantly, none of the cases which petitioner cites involves consideration of the resale price method, the approach which petitioner says should have been used in this case (Pet. 7-8). Although several cases confirm the propriety of resorting to pricing approaches other than the three methods specified in the regulations, the decisions cited by petitioner in which industry statistics were used rest upon a showing, here absent, that the data reflected arm's-length transactions substantially comparable to the controlled transactions.

For example, in *United States Gypsum Co.* v. *United States*, 452 F. 2d 445 (7th Cir. 1971), the court upheld the taxpayer's claim that shipping charges that it had paid to its subsidiary were equivalent to those that would have resulted from arm's-length dealings. On the other hand, the court sustained the Commissioner's Section 482 allocation as to sales of finished products made by the taxpayer to its Western Hemisphere Trade Corporation subsidiary, and similarly sustained the Commissioner's allocation of income from the Western Hemisphere Trade Corporation to the taxpayer arising from that subsidiary's momentary holding of title to gypsum ore. In so ruling, the court emphasized the factual nature of a Section 482 case (452 F. 2d at 448-449). Accord: *Baldwin-Lima-Hamilton Corp.* v. *United States*, 435 F. 2d 182 (7th Cir. 1970).

Cadillac Textiles, Inc. v. *Commissioner*, 34 T.C.M. 295 (1975), upon which petitioner relies (Pet. 13), is likewise distinguishable. There, the Tax Court made its own Section 482 allocation of net profits between commonly controlled corporations, including in the taxpayer's income $100,000 of profits realized by its affiliate on account of "commission weaving" for taxpayer. The court's holding was based upon its finding that the parties had not dealt at arm's length, despite its rejection of the Commissioner's allocation of $190,000 of profits (34 T.C.M. at 305-306).

PPG Industries, Inc. v. *Commissioner*, 55 T.C. 928 (1970), and *Ross Glove Co.* v. *Commissioner*, 60 T.C. 569 (1973) (Pet. 6, 12-14) similarly turn on their particular facts. In *PPG*, the Tax Court rejected a Section 482 allocation of income to taxpayer from its Swiss international sales subsidiary, finding that the prices charged by taxpayer to its subsidiary were arm's length, and that the profits earned by both were reasonable (55 T.C. at 998-999). In *Ross Glove*, the Tax Court rejected both the taxpayer's prices and the Commissioner's reallocations as not accurately reflecting arm's length prices for the goods and services which the taxpayer's Bahamian affiliate supplied to taxpayer. The Tax Court therefore made its own allocation. With regard to sales of finished gloves by the affiliate to the taxpayer, the court considered only the cost-plus method of pricing; the resale price method was not involved.

Petitioner's reliance (Pet. 14) upon *Brittingham* v. *Commissioner*, 598 F. 2d 1375 (5th Cir. 1979), and the related decision in *Dallas Ceramic Co.* v. *United States*, 598 F. 2d 1382 (5th Cir. 1979), is similarly misplaced. Neither case involved the resale price method of

determining arm's-length charges. To the contrary, the court held that the evidence did not show a shifting of income between corporations controlled by different members of the same family so as to establish a presumption of common control, and that representations made by the taxpayers to the Customs Service to the effect that invoice prices were not to be taken as arm's length for duty purposes because of the family control of the two corporations was not controlling for federal tax purposes.

It is therefore respectfully submitted that the petition a writ of certiorari should be denied.

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Solicitor General

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